Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
For Local Exchange Carriers	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262

COMMENTS OF U S WEST COMMUNICATIONS, INC.

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SUMMARY

U S WEST Communications, Inc. ("U S WEST") hereby submits its Comments in response to the Federal Communications Commission's ("Commission") Further Notice of Proposed Rulemaking ("FNPRM") in the above-referenced proceeding. The instant proceeding was initiated in response to the order of the United States Court of Appeals for the District of Columbia Circuit ("Court") reversing and remanding the Commission's selection of a 6.5% annual productivity factor (commonly referred to as the "X-factor") in its 1997 Price Cap Order.

The starting point for determining the appropriate scope of the remand proceeding must be the Court's order. As the Commission itself acknowledges, the Court did not find fault with the general methodology used by the Commission to set the X-factor, but rather the Commission's selection of inputs. Those portions of the 1997 Price Cap Order that were unaffected by the Court's decision are not subject to retroactive modification in the remand proceeding. The Court, however, did side with the local exchange carriers ("LEC") on many of the issues raised in their appeal and identify a number of specific errors in the Commission's decision-making process. Ultimately, the Court concluded that the Commission "failed to state a coherent theory supporting its choice of 6.0%," so it reversed and remanded a number of issues to the Commission for further explanation. The Court also reversed and remanded the Commission's decision to retain the 0.5% consumer productivity dividend ("CPD") in the X-factor.

Despite this clear judicial mandate, the Commission gives only cursory consideration in the FNPRM to correcting the inputs to the 1997 staff total factor productivity ("TFP") study consistent with the Court's decision. Indeed, two of the three alternative approaches for prescribing the X-factor being considered by the Commission -- the so-called "1999 staff TFP study" and the "staff Imputed X study" -- have nothing whatsoever to do with the issues on remand from the Court. In setting forth these alternative approaches, it appears that the Commission has predetermined that the X-factor must be increased, and that price caps must be modified retroactively and reinitialized as if a higher X-factor had been in effect since 1997.

U S WEST strongly opposes any proposal which involves the Commission retroactively applying an entirely new X-factor methodology and "represcribing" a higher X-factor. In order to comply with the Court's mandate, the Commission must fully address the issues which the Court reversed and remanded for further explanation. The Commission cannot circumvent the Court's decision by retroactively applying an entirely new X-factor methodology on remand so that it avoids having to correct the errors in the 1997 staff TFP study. Nor can the Commission give only cursory consideration to the Court's decision and then use an ends-driven process to select a higher X-factor. If the Commission chooses to completely abandon the X-factor methodology which it strenuously defended before the Court, then it must do so prospectively and in accordance with the Administrative Procedure Act.

Moreover, the Commission should not seek to make after-the-fact "adjustments" to the X-factor and reinitialize price caps as if a higher X-factor had been in effect since 1997. The Commission cannot justify a price cap reinitialization on the basis of a change in its X-factor methodology, as opposed to correction of an error or replacement of an interim rate with a permanent one. Such an unprecedented maneuver would be a total betrayal of the price cap compact, which is based on setting clear rules on a prospective basis to create the proper incentives. The Commission should promptly reject its reinitialization proposal before it does serious and irreparable harm to the price cap system.

U S WEST also supports the comments filed by United States Telecom Association, f/k/a United States Telephone Association ("USTA"), which demonstrate that both of the Commission's alternative X-factor methodologies are fundamentally flawed. Indeed, it appears that these alternative methodologies are specifically designed to drive up the X-factor. This type of ends-driven approach to selecting the X-factor is precisely what led the Court to reverse and remand the Commission's 1997 Price Cap Order. The Commission should not repeat its mistake here.

U S WEST agrees with USTA that the Commission should correct the errors in the 1997 staff TFP study consistent with the Court's decision. As USTA demonstrates, making these corrections would reduce the X-factor below the current 6.5% level. On a going-forward basis, the Commission should update the staff 1997 TFP study, eliminate the 0.5% CPD and disregard most of the one-sided “adjustments” proposed by the staff in its 1999 staff TFP study. This, too, will result in an X-factor below the current level. The Commission should completely reject the staff Imputed X study because it would undo most, if not all, the efficiency incentives created by price caps.

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U S WEST Communications, Inc. ("U S WEST") hereby submits its Comments in response to the Federal Communications Commission's ("Commission") Further Notice of Proposed Rulemaking ("FNPRM") in the above-referenced proceeding.[1] The instant proceeding was initiated in response to the order of the United States Court of Appeals for the District of Columbia Circuit ("Court") reversing and remanding the Commission's selection of a 6.5% annual productivity factor (commonly referred to as the "X-factor") in its 1997 Price Cap Order.[2]

I. INTRODUCTION

On remand, the Commission has a legal obligation to carry out the Court's

[1] In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform, CC Docket Nos. 94-1 and 96-262, Further Notice of Proposed Rulemaking, FCC 99-345, rel. Nov. 15, 1999 ("FNPRM").

[2] In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform, 12 FCC Rcd. 16642 (1997) ("1997 Price Cap Order"), rev. and remanded in part U.S. Telephone Ass'n v. FCC, 188 F.3d 521 (D.C. Cir. 1999) ("USTA v. FCC"). The Court agreed to stay issuance of its mandate until Apr 1, 2000 in order to give the Commission time to conduct the remand proceeding.

judgment by fully addressing the issues reversed and remanded by the Court. This can be accomplished only if the Commission corrects the errors identified by the Court and prescribes an X-factor that is supported by a "rational explanation."[3] The Commission cannot circumvent the Court's decision by retroactively applying an entirely new X-factor methodology so that it never reaches the issues reversed and remanded by the Court.

The starting point for determining the appropriate scope of the remand proceeding must be the Court's order. As the Commission itself acknowledges, the Court did not find fault with the general methodology used by the Commission to set the X-factor, but rather the Commission's selection of inputs.[4] Those portions of the 1997 Price Cap Order that were unaffected by the Court's decision are not subject to retroactive modification in the remand proceeding. The Court, however, did side with the local exchange carriers ("LEC") on many of the issues raised in their appeal and identify a number of specific errors in the Commission's decision making process.[5] Ultimately, the Court concluded that the Commission "failed to state a coherent theory supporting its choice of 6.0%," so it reversed and remanded the Commission's decision for further explanation.[6] The Court also reversed and remanded the Commission's decision to retain the 0.5% consumer productivity

[3] See, USTA v. FCC, 188 F.3d at 525.

[4] FNRPM ¶ 25.

[5] The Court rejected the various arguments raised by MCI and Ad Hoc in their separate appeals of the 1997 Price Cap Order. See USTA v. FCC 821 F.3d at 527-30.

[6] See, USTA v. FCC, 188 F.3d at 526.

dividend ("CPD") in the X-factor.[7]

Despite this clear judicial mandate, the Commission gives only cursory consideration in the FNPRM to correcting the inputs to the 1997 staff total factor productivity ("TFP") study consistent with the Court's decision. Indeed, two of the three alternative approaches for prescribing the X-factor being considered by the Commission -- the so-called "1999 staff TFP study" and the "staff Imputed X study" -- have nothing whatsoever to do with the issues on remand from the Court. Specifically, the 1999 staff TFP study makes extensive "adjustments" to the 1997 staff TFP study and changes almost every variable in the X-factor formula. Each and every one of these adjustments has the effect of driving up the X-factor. The staff Imputed X study is essentially a rate-of-return methodology which calculates a hypothetical X-factor that supposedly would have been required to produce revenues equal to costs in a competitive market. In setting forth these alternative approaches, it appears that the Commission has predetermined that the X-factor must be increased, and that price caps must be modified retroactively and reinitialized as if a higher X-factor had been in effect since 1997.[8]

U S WEST strongly opposes any proposal which involves the Commission retroactively applying an entirely new X-factor methodology and "represcribing" a higher X-factor. Such an approach would directly conflict with the Court's mandate.

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[7] Id. at 527.

[8] FNPRM ¶¶ 2, 45. The Commission states that calculations used to set prior year X-factors may have been set too low and seeks comment on whether a CPD should be included "to reduce rates and correct for prior years when the X-factor may have been set too low." Id. ¶ 45.

The Commission must carry out the Court's judgment by fully addressing the issues that were reversed and remanded for further explanation. It cannot attempt to bypass the Court's decision by "changing the rules of the game" so that it avoids having to correct the errors in the 1997 staff TFP study. That would effectively moot the Court's decision and would undoubtedly lead to further litigation. If the Commission chooses to completely abandon the X-factor methodology which it strenuously defended before the Court, then it must do so <u>prospectively</u> and in accordance with the Administrative Procedure Act.

Moreover, the Commission should not seek to make after-the-fact "adjustments" to the X-factor and reinitialize price caps as if a higher X-factor had been in effect since 1997. The Commission cannot justify a price cap reinitialization on the basis of a change in its X-factor methodology, as opposed to correction of an error or replacement of an interim rate with a permanent one. Such an unprecedented maneuver would be a total betrayal of the price cap compact, which is based on setting clear rules on a <u>prospective</u> basis to create the proper incentives. The Commission should promptly reject its reinitialization proposal before it does serious and irreparable harm to the price cap system.

U S WEST also supports the comments being filed concurrently by United States Telecom Association, f/k/a United States Telephone Association ("USTA"), which demonstrate that both of the Commission's alternative X-factor methodologies are fundamentally flawed. Indeed, it appears that these alternative methodologies are specifically designed to drive up the X-factor. This type of ends-driven approach to selecting the X-factor is precisely what led the Court to reverse and remand the Commission's 1997 Price Cap Order. The Commission should not repeat its mistake here.

U S WEST agrees with USTA that the Commission should correct the errors in the 1997 staff TFP study consistent with the Court's decision. As USTA demonstrates, making these corrections would reduce the X-factor below the current 6.5% level. On a going-forward basis, the Commission should update the staff 1997 TFP study, eliminate the 0.5% CPD and disregard most of the one-sided "adjustments" proposed by the staff in its 1999 staff TFP study. This, too, will result in an X-factor below the current level. The Commission should completely reject the staff Imputed X study because it would undo most, if not all, the efficiency incentives created by price caps.

II. THE COMMISSION CANNOT CIRCUMVENT THE COURT'S DECISION BY RETROACTIVELY APPLYING AN ENTIRELY NEW X-FACTOR METHODOLOGY ON REMAND

In order to comply with the Court's mandate, the Commission must fully address the issues which the Court reversed and remanded for further explanation. The Commission cannot circumvent the Court's decision by retroactively applying an entirely new X-factor methodology on remand so that it avoids having to correct the errors in the 1997 staff TFP study. Nor can the Commission give only cursory consideration to the Court's decision and then use an ends-driven process to select a higher X-factor. Either approach to prescribing the X-factor would directly conflict with the Court's order and produce an X-factor that, once again, is legally unsupportable.

On remand, the Commission must give full force and effect to the Court's decision by correcting the errors in the 1997 staff TFP study. The Court has not yet issued its mandate and thus it retains ongoing jurisdiction over the remand proceeding. Even if that were not the case, it is settled law that "the mandate of a court issuing a final judgment carries force beyond a victory in the immediate court."[9] In the recent case of Qualcomm v. FCC, the D.C. Circuit reiterated that "the actions of a court in setting aside the order of the Commission are not an empty gesture, but rather a judgment that is the final and indisputable basis of action" as between the Commission and an appellant.[10]

Further, in prior cases, the D.C. Circuit has not hesitated to issue stern directions to the Commission that its actions on remand must be consistent with the Court's decision. In MCI v. FCC,[11] for example, the Court granted MCI's request for an order directing the Commission and AT&T to comply with the Court's mandate from the earlier Execunet decision.[12] The issue in that case involved MCI's ongoing attempts to offer the Execunet telephone service. After the D.C. Circuit issued the Execunet decision upholding MCI's authority to provide the Execunet service pursuant to its filed tariff, the Commission approved AT&T's refusal to provide the interconnection needed to provide the service. The Court described the situation as

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[9] Qualcomm Inc. v. FCC, 181 F.3d 1370, 1378 (D.C. Cir. 1999) ("Qualcomm v. FCC").

[10] Id. (internal quotations omitted).

[11] MCI Telecommunications Corp. v. FCC, 580 F.2d 590 (D.C. Cir. 1978) ("MCI v. FCC"), cert. denied sub nom. United States Independent Tel. Assoc. v. MCI Telecommunications Corp., 439 U.S. 980 (1978).

follows:

> Having successfully litigated the question of its right to provide Execunet service, MCI certainly has good cause to feel that this subsequent turn of events engineered by the Commission and AT&T is strikingly unfair. Of course, as AT&T and the Commission so vigorously argue, litigation in the courts does not always provide the victor with all that he might wish, or with all that he expected or thought he had won. But the fact of the matter is that our Execunet decision did clearly contemplate -- by virtue of AT&T's representations and actions -- that AT&T was required to provide interconnections for Execunet service.[13]

According to the Court, not only had the Commission acted in "direct and explicit contradiction" of its Execunet decision, but its actions were inconsistent with the decision "at the more general level as well."[14] The Court responded by issuing a strong decision directing the Commission to comply with its mandate.

Under settled law, therefore, the Commission's actions in the instant remand proceeding must be consistent with the Court's decision. As the Commission itself emphasizes in the FNPRM, "[t]he court did not find fault with the 1997 staff TFP study, and did not ask us to revisit it."[15] U S WEST agrees that the appellants did not challenge -- and the Court did not find fault with -- the Commission's general methodology in the 1997 staff TFP study. Rather, the LECs' appeal and the resulting Court decision identified specific errors in the Commission's process of selecting inputs which led to the 6.5% X-factor. The Commission has no authority to retroactively modify those portions of the 1997 Price Cap Order that were

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[12] Id. at 590 (citing to MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir. 1977), cert. denied, 98 S.Ct. 781 (1978) ("Execunet").

[13] Id. at 594-5.

[14] Id. at 596.

unaffected by the Court's decision. On remand, the Commission must carry out the Court's judgment by correcting the inputs to the 1997 staff TFP study and prescribing an X-factor that is supported by a "rational explanation."

If the Commission chooses to completely abandon the X-factor which it strenuously defended before the Court, then it must do so on a prospective basis only. The Commission cannot circumvent the Court's order by retroactively applying a new X-factor methodology so that it never reaches the issues that were reversed and remanded. Any attempt to do so would be in blatant disregard of the Court's specific directives. As in Qualcomm v. FCC, the Court has given express instructions to the Commission on remand, and the Commission must give "immediate and effective relief" to the LECs in accordance with the Court's mandate.[16] Because the Court has ongoing jurisdiction, the Commission "must ensure deference to the court's intention in its disposition" of the remand proceeding.[17] Accordingly, the Commission has limited discretion in the remand proceeding and must comply with the Court's mandate.

The Commission must also do more than give cursory consideration to the Court's decision, which identified a number of very specific errors in the 1997 staff TFP study. In particular, the Court held that the Commission:

- failed to provide a rational explanation for its choice of a 6.0% X-factor after it established a range of reasonableness from 5.2% to 6.3%;

[15] FNPRM ¶ 25.

[16] Qualcomm v. FCC, 181 F.3d at 1378.

[17] Id.

- failed to provide an explanation for dismissing the 1986 productivity value of -0.5% as "improbable;"

- failed to explain its assumption that the then-recent upward trend of the X-factor would continue; and

- failed to explain why it gave some weight to the AT&T methodology which it had previously rejected.[18]

The Court ultimately concluded that the Commission "failed to state a coherent theory supporting its choice" of a 6.0% X-factor and further concluded that the Commission failed to explain its continued inclusion of a 0.5% CPD in the X-factor.[19]

Nevertheless, the Commission characterizes the Court's decision as a "limited" critique of its 1997 staff TFP study which merely questioned the Commission's "selection of [an X-factor] value at the upper end of the reasonableness range, and with the upward adjustment to the reasonable range."[20] Nowhere in the FNPRM does the Commission analyze or seek comment on the particular issues reversed and remanded by the Court for further explanation. According to the Commission, the Court's remand requires only that it justify its X-factor selection from within its previously established range of reasonableness if it sets the X-factor using the 1997 staff TFP study.[21] These statements do not indicate any willingness on the part of the Commission to seriously address the issues which the Court held require further explanation.

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[18] See, USTA v. FCC, 188 F.3d at 525-6.

[19] Id. at 526.

[20] FNPRM ¶ 25.

[21] Id. ¶ 27.

In order to carry out the Court's judgment, the Commission will have to do more than pay lip service to the Court decision. U S WEST agrees with USTA that the Commission cannot support its original selection of inputs for the 1997 staff TFP study and, therefore, it must correct the study consistent with the Court's decision. As USTA demonstrates, using the proper inputs for the Commission's staff 1997 TFP study results in an X-factor that is below the current 6.5% level. That is the only retroactive modification to the X-factor that is permitted under the Court's decision.

III. THE COMMISSION CANNOT JUSTIFY A PRICE CAP REINITIALIZATION ON THE BASIS OF A CHANGE IN ITS X-FACTOR METHODOLOGY

The Commission cannot justify a price cap reinitialization on the basis of a change in X-factor methodology, as opposed to correction of an error or replacement of an interim rate with a permanent one. Such an unprecedented maneuver would be a total betrayal of the price cap compact, which is based on setting clear rules on a prospective basis to create the proper incentives. The Commission should promptly reject its reinitialization proposal before it does serious and irreparable harm to the price cap system.

The illegitimacy of the Commission's reinitialization proposals is particularly obvious with respect to the staff Imputed X study. It is impossible to overstate the extent to which the staff Imputed X study represents a striking departure from the Commission's current price cap regulatory regime. The Commission implemented price caps in 1990 "because it found that rate-of-return regulation did not create adequate efficiency incentives for incumbent LECs, and required administratively burdensome cost allocation rules to enforce."[22] Rather than allowing LECs to earn a predetermined rate-of-return, price cap regulation directly regulates prices and allows earnings to vary. The Commission's rules create incentives for price cap LECs to become more efficient while keeping their rates below the established ceilings, as adjusted annually by a measure of inflation minus the X-factor.[23]

In its appellate brief defending its 1997 Price Cap Order, the Commission described how price caps succeeded in eliminating the drawbacks inherent in rate-of-return regulation:

> Under a price cap system, the regulator sets a maximum price, and the firm selects rates at or below the cap. Because cost savings do not trigger reductions in the cap, the firm has a powerful profit incentive to reduce costs.[24]

The proposed staff Imputed X study would eliminate the efficiency-maximizing incentives created by price caps. Specifically, the Commission's proposed staff Imputed X study calculates a hypothetical X-factor that supposedly would have been required to produce revenue equal to costs in a competitive market.[25] This methodology is essentially a rate-of-return calculation whereby the Commission determines the appropriate earnings level for price cap LECs based on its own evaluation of costs and establishes an interstate-only X-factor.[26] Thus, adoption of

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[22] 1997 Price Cap Order, 12 FCC Rcd. at 16646 ¶ 3.

[23] Id.

[24] FCC Brief in Case No. 97-1469, filed June 15, 1998 at 12 ("FCC Brief") (citing National Rural Telecom Ass'n v. FCC, 988 F.2d 174, 177-79 (D.C. Cir. 1993)).

[25] FNPRM ¶ 36.

[26] Id. ¶ 37.

the staff Imputed X study would constitute a 180 degree turn away from incentive-based price cap regulation.

The reinitialization of price caps to reflect an entirely new X-factor methodology would be an unprecedented maneuver that would completely undermine the legitimacy of the Commission's price cap system.[27] Unlike previous instances where the Commission reinitialized price caps to reflect a higher X-factor, the Commission cannot claim to be correcting an error or replacing an interim X-factor with a permanent one. In 1997, for example, the Commission was extremely cautious about reinitializing price caps to reflect a one-year retroactive increase in the X-factor. The Commission believed that its repeated emphasis that the current X-factor was "interim" should have put carriers on notice that an adjustment was possible, perhaps beginning with the 1995 tariff year.[28] Nevertheless, the Commission was careful to "limit harm to LEC productivity incentives that could result from the perception that our regulatory policies unnecessarily lack constancy."[29] The Commission limited its reinitialization to one year in recognition of the fact that the longer period of reliance on the interim X-factor had "prompted a longer period of relative uncertainty than intended."[30]

Ironically, the Commission's brief filed with the D.C. Circuit strongly defended its decision not to reinitialize back to 1991, or at least to 1995, as the

[27] The serious flaws in the staff Imputed X study are discussed further in the following section.

[28] 1997 Price Cap Order, 12 FCC Rcd. at 16714 ¶ 179.

[29] Id.

interexchange carrier petitioners had argued. The Commission distinguished its previous decision in Bell Atlantic to require such a reinitialization back to 1991, which corrected an error in its original calculation of the X-factor.[31] In this case, however, the Commission "did not simply correct an error in a prior X-Factor calculation: It adopted an entirely new method of calculating the X-Factor and relied upon new data covering a different time period."[32] The Commission argued that, after considering the need to correct any understatement in the X-factor and the need to respect the "reliance interests" of the LECs, "[s]triking this balance in favor of a one-year recalibration was entirely reasonable."[33] Ultimately, the Court upheld the Commission's decision, reiterating that "[u]niversal, complete reinitialization would impair the supposed incentive advantages of price caps -- which derive from firms' supposing that their efficiencies will *not* come back to haunt them."[34]

In this case, the Commission cannot claim to have considered the LECs' "reliance interests" or put them on notice of a potential reinitialization of price caps for the past three years. To the contrary, the Commission went out of its way in 1997 to "provide certainty for the industry" until the next performance review.[35] In

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[30] Id.

[31] FCC Brief at 24, citing to Bell Atlantic Co. v. FCC, 79 F.3d 1195 (D.C. Cir. 1996) ("Bell Atlantic").

[32] FCC Brief at 46.

[33] Id. at 47.

[34] USTA v. FCC, 188 F.3d at 530.

[35] 1997 Price Cap Order, 12 FCC Rcd. at 16707 ¶ 166.

fact, the Commission made the following commitment:

> To achieve the benefits of which they are capable, price cap regulation should not replicate rate-of-return regulation. Therefore, in the next performance review, we would plan to focus on ensuring, to the extent possible, that any adjustments to our rules would not substantially undermine each price cap incumbent LEC's incentives to improve its efficiency, particularly if similar adjustments may be made in other future performance reviews.[36]

Making after-the-fact adjustments to the X-factor methodology three years later would represent a complete reversal of the Commission's previous position without the requisite advance notice to price cap LECs.

As the Commission has previously recognized, after-the-fact modifications to the price cap rules of the type and magnitude being proposed here are anathema to price cap regulation, which is based on maintaining clear prospective rules that create incentives to maximize efficiency. Manipulating the X-factor to restrict LEC earnings undermines the very goal of price caps -- to encourage price cap LECs to operate more efficiently while maintaining or lowering rates.[37] Even the suggestion of reinitializing price caps to reflect a new X-factor methodology calls into serious

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[36] Id. at 16714 ¶ 180.

[37] In a separate proceeding, the Commission has proposed to reinitialize the price cap LECs' traffic-sensitive and trunking baskets as if they had contained a "q" factor since 1991. In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd. 14221, 14330-1, 14333 ¶¶ 218, 225 (1999) ("Pricing Flexibility FNPRM"), appeal pending sub nom. MCI WorldCom, Inc. v. FCC, File No. 99-1395 (and consolidated Nos. 99-1404 and 99-1472) filed Sep. 23, 1999 (D.C. Cir.). U S WEST has raised similar concerns in that proceeding that the Commission's proposed adjustment threatens to undermine the incentive-based

question the Commission's credibility and continued commitment to the regulatory compact of price caps. The Commission should promptly reject its reinitialization proposal before it does serious and irreparable harm to the price cap system.

IV. BOTH OF THE ALTERNATIVE X-FACTOR STUDIES DEVELOPED BY COMMISSION STAFF ARE FUNDAMENTALLY FLAWED

The majority of the FNPRM is devoted to discussing two alternative X-factor studies developed by Commission staff, rather than correcting the errors in the 1997 staff TFP study identified by the Court. Both of these alternative methodologies are fundamentally flawed and appear specifically designed to drive up the X-factor. This type of ends-driven approach to selecting an X-factor is precisely what led the Court to reverse and remand the Commission's 1997 Price Cap Order. The Commission should not repeat its mistake here.

A. 1999 Staff TFP Study

While the 1999 staff TFP study uses the same general methodology as the 1997 study, almost every input has been modified in some way. Each and every "adjustment" proposed by the Commission would have the effect of driving up the X-factor. That fact alone raises serious doubts about the legitimacy of the Commission's proposal. The assessment of Professor Frank M. Gollop, which is being submitted with USTA's comments demonstrates that making the appropriate corrections to the 1999 staff TFP study would reduce the X-factor below the current 6.5% level.

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price cap system. Comments of U S WEST filed Oct. 29, 1999, CC Docket Nos. 96-262 and 94-1 and CCB/CPD File No. 98-63 at 16-19.

There are a multitude of errors in the 1999 staff TFP study that would artificially inflate the X-factor. Because USTA is addressing these and other issues in detail, U S WEST will touch on only a few of the errors in the study. First, the Commission should use access lines, not dial equipment minutes ("DEM"), to measure local output. Because the majority of intrastate revenue is related to lines rather than usage, the Commission should utilize lines to measure productivity growth. This ensures that the measure of output corresponds to the outputs driving revenue growth.

Second, the Commission should not use the Moody's Baa bond ratings to measure LEC opportunity costs. While a safe government bond may present a good investment opportunity for a conservative individual investor, LECs and their investors would likely invest available funds in an industrial enterprise. Further, in recent years, bond ratings have trended downward while the rate-of-return for the Value Line industrials has increased steadily. The opportunity cost for LECs and their investors is more accurately calculated by looking at the returns enjoyed by like-sized firms, not by the return on bonds.

Third, the Commission improperly excludes labor separation payments from labor expenses. Contrary to the Commission's characterization of severance payments as exogenous changes, such payments are legitimate labor expenses that are incurred by rational companies throughout the highly competitive telecommunications industry. Thus, severance payments must be included in labor expenses as an inherent cost of hiring and retaining employees.

B. Staff Imputed X Study

The Commission should not adopt the staff Imputed X study, which is a fundamentally flawed rate-of-return methodology for setting the X-factor. In the FNPRM, the Commission defends the staff Imputed X study by asserting that it "appears to have modest data requirements" while retaining the "same incentive effects" as the TFP approach.[38] Neither of these assertions is valid.

By attempting to prescribe an X-factor based on interstate expenses and revenue,[39] the staff Imputed X study relies on data which is meaningless. Professor William E. Taylor, whose analysis is being submitted with USTA's comments, correctly points out that due to the presence of common costs in the provision of interstate and intrastate services, productivity growth for interstate services cannot accurately be defined. The Commission itself defended its reliance on total company productivity before the D.C. Circuit and opposed MCI's argument in favor of interstate productivity, questioning "whether it would be possible to develop separate production functions for interstate and intrastate services."[40] Inexplicably, the Commission has now set forth an X-factor methodology based on interstate productivity with no acknowledgment of its consistent opposition to such an approach.

Any attempt by the Commission to determine interstate productivity would

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[38] FNPRM ¶ 35.

[39] Id. ¶ 3.

[40] USTA v. FCC, 188 F.3d at 528 citing 1997 Price Cap Order. See also FCC Brief at 41-42.

be grossly distorted by the separations process. It should be beyond dispute that the Commission's Part 36 rules do not assign costs in a manner that accurately reflects cost causation. The Internet is perhaps the best example of the distortions that occur in the separations process -- Internet minutes continue to be assigned to the intrastate jurisdiction even though the Commission has determined that Internet calls are jurisdictionally interstate. As a result, assigning costs and revenues for Internet calls to the intrastate jurisdiction artificially inflates interstate earnings and deflates intrastate earnings. The staff Imputed X study would incorporate the arbitrary effects of the separations process into the X-factor value.

From a policy perspective, adoption of the staff Imputed X-factor study would represent a giant step backward for the Commission and would undo most, if not all, the efficiency incentives created by price caps. As the Commission states in the FNPRM, "[t]he introduction of LEC price cap regulation was expected to stimulate cost reduction and accelerate technological innovation because the regulated firms would be able to benefit from such behavior as they could not do under rate-of-return regulation."[41] By prescribing the X-factor so that revenues are equal to costs (including the Commission's view of a competitive cost of capital), the staff Imputed X study would mark an unfortunate return to rate-of-return regulation.

It is noteworthy that the Commission previously rejected AT&T's Historical Revenue Approach (which is similar to the Commission's staff Imputed X study) on

[41] FNPRM ¶ 6.

the basis that it would “create substantially similar incentives to those under rate-of-return regulation” and “might not provide sufficient incentives for productivity growth.”[42] In the FNPRM, the Commission acknowledges its previous rejection of AT&T’s Historical Revenue Approach “due to administrative concerns and incentive effects,” but it fails to explain why those concerns are no longer valid.[43] Given the Court’s holding that the Commission’s partial reliance on aspects of the previously rejected AT&T methodology was “irrational,”[44] the Commission would be hard-pressed to explain why it is now proposing to essentially adopt AT&T’s methodology -- which is completely at odds with incentive-based price cap regulation -- in its entirety in the remand proceeding.

V. THE COMMISSION CANNOT JUSTIFY CONTINUED APPLICATION OF THE CPD

The Commission originally adopted a CPD of 0.5% when it first transitioned from rate-of-return to price cap regulation to ensure that customers would benefit from price caps in the form of reduced rates.[45] On appeal, the LECs argued that the Commission failed to provide any justification for retaining a CPD in the 1997 Price Cap Order, since its original justification was no longer valid. In response, the Commission argued before the D.C. Circuit that it relied on the elimination of earnings sharing to justify continuing the CPD. The Court found that the

[42] 1997 Price Cap Order, 12 FCC Rcd. at 16653-4 ¶ 22.

[43] FNPRM ¶ 39.

[44] See USTA v. FCC, 188 F.3d at 526.

Commission had failed to justify its retention of a 0.5% CPD in the X-factor given its newly-presented justification.[46]

As Professor Taylor demonstrates (see Comments of USTA filed concurrently herein), continuing to apply a 0.5% CPD constitutes double-counting because the measurement of historical productivity growth through 1998 includes the significant growth that has occurred without sharing. Most of the effects of the elimination of sharing have already been reflected in measuring productivity growth since 1995.[47] In short, whatever purpose the 0.5% CPD may have originally served, it certainly is not needed to ensure that customers benefit from the elimination of sharing.

VI. CONCLUSION

For these reasons, the Commission should carry out the Court's judgment by making the necessary corrections to the 1997 staff TFP study. As USTA demonstrates, making these corrections would reduce the X-factor below the current 6.5% level. On a going-forward basis, the Commission should update the 1997 staff

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[45] Id. at 527, citing to In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786, 6799 ¶ 100 (1990) ("1990 Price Cap Order").

[46] USTA v. FCC, 188 F.3d at 527.

[47] Price cap LECs have had the option of avoiding some earnings sharing for interstate services since 1991 and all earnings sharing since 1995. U S WEST and a number of other price cap LECs chose a higher X-factor with less stringent sharing requirements during the period from 1991 to 1994. In addition, the vast majority of price cap LECs migrated to a higher X-factor with no sharing in their 1995 and 1996 Annual Price Cap Tariff filings. U S WEST selected the no-sharing option retroactively on January 1, 1997 through a waiver request granted by the Commission on June 26, 1997.

TFP study, eliminate the 0.5% CPD and disregard most of the one-sided "adjustments" proposed by the staff in its 1999 staff TFP study. This, too, will result in an X-factor below the current level. The Commission should completely reject the staff Imputed X study because it would because it would undo most, if not all, the efficiency incentives created by price caps.

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January 7, 2000

CERTIFICATE OF SERVICE

I, Kristi Jones, do hereby certify that I have caused 1) the foregoing **COMMENTS OF U S WEST COMMUNICATIONS, INC.** to be filed electronically with the FCC by using its Electronic Comment Filing System, 2) a copy of the **COMMENTS** to be served, via hand delivery, upon the persons/entity listed (marked with an asterisk) on the attached service list, and 3) a courtesy copy of the **COMMENTS** to be served, via hand delivery, upon all other persons listed on the attached service list.

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